DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: JEFFREY DORFMAN
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SUBJECT:

This Field Service Advice responds to your memorandum dated December 15, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

FCorp =
FSub =
Country F =
Currency F =
USHolding =
USub1 =
USub2 =
Date1 =
Date2 =
Date3 =
Date4 =
Date5 =
Date6 =

ww	=
xx	=
yy	=
zz	=
SumA	=
SumB	=
SumC	=
aa	=
bb	=
cc	=
dd	=
ee	=

ISSUE:

Whether the transfer of a foreign currency denominated debt by a foreign parent to its U.S. subsidiary and the subsequent transfer of that debt by the U.S. subsidiary to a second-tier U.S. subsidiary constitute valid contributions to capital under I.R.C. §351.

CONCLUSION:

Yes, the two transfers do constitute valid §351 contributions.

FACTS:

The following facts have been presented for consideration. FCorp, a Country F corporation, is the sole shareholder of FSub, another Country F corporation. FCorp is also the sole shareholder of USHolding, a domestic corporation and the taxpayer in this case. USHolding holds all the shares of two domestic corporations, USub1 and USub2. USHolding and its two domestic subsidiaries are members of a U.S. consolidated group. USub1 and USub2 have the U.S. dollar as their functional currency.

On Date1, FSub loaned SumA, denominated in Currency F, to USub1 in exchange for USub1's note (the “Note”). The U.S. dollar-Currency F exchange rate on Date1 was ww:1. Approximately two years later, on Date2, FSub sold the note to FCorp for its face amount in Currency F. Currency F had appreciated vis a vis the dollar, and on Date2, the U.S. dollar-Currency F exchange rate was xx:1. The sale did not result in a currency exchange gain to FSub whose functional currency was Currency F. Nevertheless, in U.S. dollar terms, FCorp’s U.S. dollar basis in the Note was higher than FSub’s basis because of the currency fluctuation between

Date1 and Date2. While this increased U.S.-dollar basis was not directly relevant to FCorp, a Currency F taxpayer, it would be relevant to any U.S. taxpayers that would take a carry-over basis in the Note.

On Date3, one day after it purchased the Note, FCorp contributed the Note to USHolding in exchange for additional USHolding shares. The parties treated the contribution as a tax-free contribution to capital under I.R.C. §351. USHolding used the exchange rate of xx:1, which was in effect at the time of the sale of the Note by FSub, to determine its U.S.-dollar carry-over basis in the Note.

Four days later, on Date4, USHolding contributed the Note to USub2 in exchange for additional USub2 shares. USHolding's basis in the Note was carried over to USub2, and was thus based on the exchange rate of xx:1. At this point, therefore, both the issuer and the holder of the Note were members of the same consolidated group, but had different U.S. dollar bases in the Note.

Approximately 3 years later, on Date5, USub1 partially redeemed the note by making a payment of SumB in Currency F to USub2. Currency F had depreciated vis as vis the U.S. dollar from the date of the purchase of the Note by FCorp. The exchange rate in effect at the time was yy:1. USub1 claimed a foreign currency gain of $aa, measured by the difference between the exchange rate of ww:1 and yy:1. USub2, on the other hand claimed the substantially greater foreign currency loss of $bb, based on the difference between the exchange rates of xx:1 and yy:1.

The following year, on Date6, Sub1 redeemed the remainder of the Note, in the amount of SumC in Currency F. At that time, the U.S. dollar-Currency F exchange rate was zz:1. Using the above methodology, USub2 had a foreign exchange loss of $cc -- substantially greater than USub1's foreign exchange gain of $dd. Thus, in total, the USHolding consolidated group was able to report net foreign exchange losses of $ee as a result of these transactions. The taxpayer has stated that the above transactions were part of the cash management of its treasury function. You have asked whether the transfers of the Note from FCorp to USHolding, and in turn to USub2, constitute valid §351 transactions.

LAW AND ANALYSIS

Under Treas. Reg. § 1.988-2(b)(6), the obligor of a nonfunctional currency debt instrument shall realize exchange gain or loss with respect to the principal amount of such instrument on the date principal is paid to the holder. The amount of exchange gain or loss with respect to principal is determined by translating the units of nonfunctional currency principal at the spot rate on the date the obligor became the obligor and subtracting from such amount the amount computed by translating the units of nonfunctional currency principal at the spot rate on the date payment is made.

Similarly, Treas. Reg. § 1.988-2(b)(5) provides in part that the holder of a nonfunctional currency debt instrument shall realize exchange gain or loss with respect to the principal amount of such instrument on the date principal is received from the obligor. The amount of exchange gain or loss with respect to principal is determined by translating the units of nonfunctional currency principal at the spot rate on the date the payment is received and subtracting from such amount the amount computed by translating the units of nonfunctional currency principal at the spot rate on the date the holder acquired the instrument, of if applicable, the date a transferor from whom the nonfunctional principal amount is carried over acquired the instrument. Such a carried over basis will result from a nonrecognition transaction such as section 351.

Treas. Reg. §1.988-2(f) provides that if the substance of a section 988 transaction differs from its form, the timing, source, and character of gains or losses with respect to a transaction may be recharacterized by the Commissioner in accordance with its substance. For example, the regulations provide that a currency swap that requires the prepayment of all payments to be made or received may be recharacterized as a loan by the Commissioner.

Section 351(a) provides that no gain or loss is recognized where one or more persons transfer property to a corporation solely in exchange for stock in such corporation, and such person or persons are in control of the corporation immediately after the exchange. A section 351 exchange immediately followed by another section 351 exchange qualifies as a section 351 transaction. See Rev. Rul. 77-449, 1977-2 C.B. 110.

The control requirement under section 351 is defined in section 368(c). A person (or persons) must own immediately after the transfer, at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of such corporation.

The transferee corporation does not recognize gain or loss upon transfer of its stock in a section 351 transaction pursuant to section 1032. Where property is acquired in a section 351 transaction, section 362 provides that the basis of the property for the transferee corporation is the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. In a section 351 transaction, section 358 provides that a shareholder's basis in the stock received is equal to the basis in the property transferred to the corporation increased by any gain recognized on the exchange and decreased by any boot received.

The Service, under the authority granted by section 482 and the regulations thereunder, may in some cases make allocations between related parties following certain nonrecognition transactions such as section 351. See National Securities Corp. v. Comm'r, 137 F.2d 600, (3rd Cir. 1943), cert. den. 320 U.S. 794 (1943). The situations susceptible to an allocation by the Service have been separated into two categories:

> (1) cases in which property was transferred in a nonrecognition transaction and subsequently disposed of by the transferee, and in which the sole purpose of the transfer was to achieve tax consequences on the disposition of the property by the transferee that were more favorable that the tax consequences of a disposition by the transferor; and (2) cases in which the nonrecognition transfer of the property resulted in an artificial separation of income from the expenses of earning the income. (Citations omitted)

Eli Lilly and Co. v. Comm'r, 84 T.C. 996, 1118 (1985). In that case, the Tax Court refused to allow the Service's reallocation of income under section 482 subsequent to a section 351 transfer of property because it found such transfer was motivated by bona fide business reasons and the taxpayer in that case did not thereafter dispose of the transferred assets. The court did state however, that in some circumstances, a valid business purpose will not preclude the application of section 482 when necessary to clearly reflect income. Id, fn 57.

A section 351 contribution or a series of transactions including a section 351 transaction may also be invalidated under certain common law doctrines. While the language in section 351 does not expressly require a business purpose, it is the Service's position that a valid business purpose is required for nonrecognition treatment under that section. The "business purpose" doctrine originated in Gregory v. Helvering, 293 U.S. 465, (1935). According to this doctrine, a transaction is not to be given effect for tax purposes unless it serves a legitimate business purpose other than tax avoidance. Gregory established the general principle that, in order to fit within a particular provision of the Code, a transaction must satisfy not only the language of the statute, but also must have a purpose that lies within the spirit of the statute. See Gregory, 293 U.S. at 470. Courts have been willing to require a business purpose for section 351 transactions. See Caruth v. United States, 688 F. Supp. 1129, 1138-42 (N.D. Tex. 1987), aff'd as to other issues, 865 F.2d 644 (5th Cir. 1989)[1].

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[1]For a contrary view see W. & K. Holding Co. v. Commissioner, 38 B.T.A. 830 (1938), nonacq., 1939-1 C.B. 69 which held that there was no requirement of a valid business purpose under section 351.

Subsequent to several Supreme Court decisions such as Gregory, the lower courts developed the economic sham doctrine. Under this doctrine, certain transactions may be recharacterized or ignored for tax purposes if they are deemed not to have economic substance except for their tax consequences. See, e.g., ACM Partnership v. Comm'r, 73 T.C.M. (CCH) 2189, (1997), aff'd 157 F3d 231 (3rd Cir. 1998), cert. denied 119 S.Ct. 125 (1999). This line of cases, however, is generally not applicable here because it examines transactions for their genuine profit potential whereas contributions to capital cannot generally be viewed in those terms.

Finally, we note that two other potentially applicable statutory and regulatory set of provisions are inapplicable here. I.R.C. § 267(a)(1) provides that no deduction shall be allowed in respect of any loss from the sale or exchange of property between certain related persons, including, as defined in I.R.C. §267(b)(3), members of a controlled group. Treas. Reg. § 267(f)-1(e), however, provides that section 267(a)(1) does not apply to an exchange loss realized with respect to a loan of nonfunctional currency if the loss is realized by a member of a controlled group with respect to nonfunctional currency loaned to another member, the loan is described in Treas. Reg. § 1.988-1(a)(2)(i), and the loan does not have as a significant purpose the avoidance of Federal income tax. Moreover, the consolidated return regulations at the time of the transaction did not provide guidance regarding the gain or loss on intercompany obligations held at some point by a nonmember.

Based on the above applicable law, we believe that the tax consequences of the transactions, as determined by the taxpayer, will be difficult to alter. This is because each separate transaction had significant economic consequences. FSub held the Note for two years before selling it to FCorp. Moreover, having received the Note as a contribution to capital, USub2 held it for three years before it was partially redeemed. Yet, because the sale by FSub resulted in a tax basis step-up for the subsequent holder, a mismatch of exchange gain and loss occurred among members of a U.S. consolidated group, and the transaction guaranteed the parties a pre-determined loss that would not change despite any further movement in the exchange rates. Because both the holder and the issuer were members of a group filing consolidated returns, their foreign currency exposure to fluctuations in Currency F vis a vis the dollar was hedged, and the loss resulting from the difference in their bases was locked in. It is this mismatch, and thus the guaranteed loss, that are the cause of your inquiry.

The focus of the inquiry in this case should be on either the sale of the Note by FSub to FCorp (which resulted in an increased U.S. dollar basis in the Note without a corresponding tax) or the fact that there was a mismatch of exchange gain and loss by members of a consolidated group. The validity of the section 351 contributions to capital is not critical to the transactions' tax consequences because the U.S. dollar basis of the item contributed was essentially the same as the U.S. dollar value of the item contributed. Thus, a sale by FCorp to USHolding would have resulted in the same or very similar tax consequences as a contribution to capital, in that in either case, USHolding and thus USub2 would have had essentially the same U.S. dollar basis in the Note. We nevertheless consider the validity of the section 351 contributions to capital after having examined the tax consequences of the transactions under the exchange gain or loss provisions of section 988. Finally, we consider possible recharacterizations of the transactions at issue under the business purpose and substance over form doctrines.

Section 988.

The taxpayer's computation of its exchange losses on Date5 and Date6 are generally in accord with the rules of the §988 regulations. USub1's gain was properly computed by translating the units of nonfunctional currency principal at the spot rate on the date the obligor became the obligor -- Date1, when the exchange rate was xx:1 -- and subtracting an amount computed by translating the units of nonfunctional currency principal at the spot rate on the date payment is made -- Date5, for the first redemption, and Date6, for the second redemption.

As provided by Treas. Reg. § 1.988-2(b)(5), USub2, the holder of the nonfunctional currency Note, realized an exchange loss with respect to the principal amount of such instrument on the date principal was received from USub1. The amount of this exchange loss was determined by translating the units of nonfunctional currency principal at the spot rate on the date the payment was received (Date5 and Date6) and subtracting from such amount the amount computed by translating the units of nonfunctional currency principal at the spot rate on the date FCorp, the transferor from whom the nonfunctional principal amount was carried over, acquired the instrument (Date 2). As stated above, however, the tax consequences of the transactions would not have differed much had the contribution to USHolding and USub2 been taxable.

Finally, we do not believe that the substance over form rule in §1.988-2(f) applies in this fact pattern as discussed below in the section titled "Business Purpose and Substance Over Form."

Section 351.

1) In general.

Based on the facts submitted for consideration, the two transfers at issue here do qualify as section 351 contributions by FCorp to USHolding and by the latter to USub2, as the requirements of that section were met. As a result, USub2 takes a carryover basis in the Note determined based on the transferor's basis, which in turn is determined according to the exchange rate in effect when FCorp purchased the Note from FSub. As a result of this carryover basis, USub2 will have a different basis in the foreign currency denominated Note than USub1, its issuer. USub2's basis is higher than the value of the Note at the time of repayment. Thus, because of the application of section 351, USub2 will have a loss in excess of the gain recognized by USub1, resulting in a mismatch of the gains and losses of the members of the consolidated group. The remaining issue is whether another provision will alter this result.

2) Interaction with section 482.

The facts presented do not meet the threshold set by the Tax Court in Eli Lilly in that they do not reveal that "the sole purpose of the transfer was to achieve tax consequences on the disposition of the property by the transferee that were more favorable than the tax consequences of a disposition by the transferor." Eli Lilly, at 1120. Moreover, this case does not involve the separation of expenses and the income from the same item. Consequently, the Service's powers under section 482 may not be invoked here.

Business purpose and substance over form.

The economic effect of the transactions was (1) to allow FSub, the original holder of the Note, to receive cash in exchange for the Note, and (2) resulted in the contribution to USub2 of an interest-bearing obligation which it held for a total of four years before full redemption for cash. Any recharacterization of the transactions under the substance over form doctrine should leave the parties in the same ultimate economic positions. Consequently, FSub cannot be deemed to have distributed the Note to FCorp as a dividend because this recharacterization does not account for the cash that FSub received in exchange for the Note. In addition FSub cannot be deemed to have contributed the Note to USHolding in a tax-free contribution to capital because (1) FSub is not a shareholder in USHolding and (2) this does not account for the cash FSub received.

It is important to understand that the related parties described above had many alternatives to lock in and realize the inherent currency losses in the note while leaving them in the same economic position. One reasonable recharacterization of the transactions would be to treat them as a contribution of cash by FCorp to USHolding which would contribute the cash to USub2, followed by the purchase of the Note by USub2 from FSub. Thus, FSub would receive cash in exchange for the Note, while USub2 would hold the Note. This recharacterization, however, does not affect the transaction's tax consequences. Under this recharacterization, the purchase of the Note would give USub2 essentially the same U.S. dollar basis as when the Note was contributed to it by FCorp – a basis based on the exchange rate in effect at the time of the sale of the Note by FSub – and would still cause the mismatch of exchange gains and losses at issue.

Because other viable structures would have yielded the same tax consequences, we do not believe that application of the substance over form rule in §1.988-2(f) is appropriate in this setting.

Section 267 and the consolidated return provisions.

As stated above, the regulations promulgated under section 267 specifically provide that they do not apply to the situation at hand unless the loan had as a significant purpose the avoidance of Federal income tax. No such evidence was presented here. In addition, during the years at issue, the consolidated return regulations in effect at the time of the transaction did not provide guidance regarding the gain or loss of intercompany obligations held at some point by a nonmember, and the mismatch at issue cannot be disallowed under those provisions.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

If you have any further questions, please call (202) 622-3870.

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